THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE

The Congress of the United States
Congressional Budget Office

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NOTES

Unless otherwise indicated, all years referred to in Chapter 1 are calendar years and all years in Chapter 2 are fiscal years.

Some figures in Chapter 1 indicate periods of recession using shaded vertical bars. The bars extend from the peak to the trough of the recession.

The economic outlook discussed in Chapter 1 is considered to be a forecast through the end of 1996 and a projection for 1997 through 2005. The forecast attempts to anticipate the cyclical movements in the economy and the effects of fiscal policy on the year-to-year changes in economic activity. The economic projection is designed to estimate the growth rates that will prevail on average for the entire period.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Numbers in the text and tables may not add to totals because of rounding.

National income and product account data shown in the tables do not incorporate the data for the second quarter of 1995, which were released on July 28, 1995.

Preface

This volume is one of a series of reports on the state of the economy and the budget that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(f) of the Congressional Budget Act of 1974 for CBO to submit periodic reports to the Committees on the Budget with respect to fiscal policy and to provide five-year baseline projections of the federal budget. In accordance with CBO's mandate to provide objective and impartial analysis, the report contains no recommendations.

The analysis of the economic outlook presented in Chapter 1 was prepared by the Macroeconomic Analysis Division under the direction of Robert Dennis and John F. Peterson. Robert Arnold wrote the chapter. Matthew Salomon carried out the economic forecast and projections. Laurie Brown, Douglas Elmendorf, Victoria Farrell, Douglas Hamilton, Adrienne Kearney, Kim Kowalewski, Joyce Manchester, Angelo Mascaro, Benjamin Page, Frank Russek, Matthew Salomon, John Sturrock, and Christopher Williams provided comments and background analysis. Matthew Salomon and Laurie Brown wrote Appendix A, and John F. Peterson wrote Appendix B. Derek Briggs, John Romley, and Jennifer Wolfson provided research assistance.

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision of Paul N. Van de Water, Robert Sunshine, Paul Cullinan, Peter Fontaine, James Horney, Michael Miller, and Murray Ross. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Rosemary D. Marcuss and Richard Kasten. Jeffrey Holland wrote Chapter 2, with assistance from Susan Strandberg and Michael Simpson, and Chapter 4. Robert Dennis and James Horney wrote Chapter 3. Daniel Kowalski wrote Appendix C, Jeffrey Lemieux wrote Appendix D, and James Horney wrote the summary of the report.

An early version of the economic forecast underlying this report was discussed at a meeting of CBO's Panel of Economic Advisers. Members of this panel are Michael Boskin, Barry P. Bosworth, Robert Dederick, Martin Feldstein, Benjamin Friedman, Lyle E. Gramley, Robert E. Hall, Marvin Kosters, Anne Krueger, Burton Malkiel, Gregory Mankiw, Allan Meltzer, Rudolph Penner, James Poterba, William Poole, Robert Reischauer, Sherwin Rosen, Robert Solow, John Taylor, and James Tobin. Richard Berner, David Bradford, Enrique Mendoza, and Robert Van Order attended as guests. Although these outside advisers provided considerable assistance, this document does not necessarily reflect their views.

Paul L. Houts and Sherry Snyder edited the report, with the assistance of Christian Spoor. The authors owe thanks to Marion Curry, Dorothy Kornegay, and Linda Lewis, who assisted in the preparation of the report. Kathryn Quattrone prepared it for final publication.

June E. O'Neill
Director

August 1995

Contents

APPENDIXES

TABLES

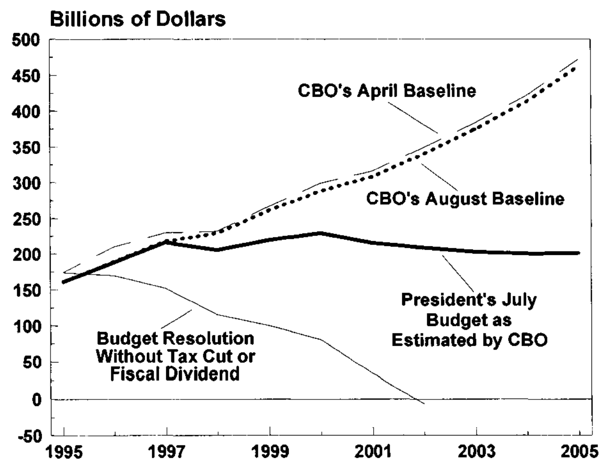
FIGURES

BOX

Summary

The Congressional Budget Office (CBO) projects that this year's deficit will be $161 billion--the lowest in relation to the size of the economy since 1979. Nevertheless, although the deficit for fiscal year 1995 is $13 billion lower than CBO estimated in April, CBO's longer-term projections of federal spending and revenues under current policies have changed little since it published its April baseline (see Summary Figure 1). CBO still believes that, after declining for three consecutive years, the deficit will begin to grow again in fiscal year 1996 if current laws affecting the budget do not change. Assuming that discretionary spending increases at the rate of inflation after the statutory caps on such spending expire in 1998, CBO projects that the deficit will rise to $462 billion in 2005. The increase is not as steep in those CBO projections that assume discretionary spending is frozen at the nominal 1998 level, but the deficit still climbs to $292 billion in 2005.

Summary Figure 1.
Comparison of Projected Deficits (By fiscal year)



SOURCE: Congressional Budget Office.

In a similar vein, since its last forecast CBO has lowered its estimate of economic growth and interest rates for the current year, but it has not changed its assessment of longer-term economic trends in any significant way. The real growth of only 1.3 percent now forecast for calendar year 1995 represents a dramatic slowdown from the 4.1 percent rate of growth experienced during 1994. It is also markedly slower than the 2.5 percent CBO forecast last winter. Some analysts fear that the slow growth recorded in the first half of 1995 might signal the early stages of a recession. Although CBO recognizes the possibility that a recession might occur, the economy appears to be fundamentally sound and the usual signs of an impending recession are absent. CBO's forecast assumes that the pace of economic growth will pick up in 1996, with output increasing at a real (inflation-adjusted) rate of 2.3 percent.

Neither the recent performance of the economy nor any other development prompted a substantial change in CBO's longer-term economic projections. CBO projects that the economy will grow in real terms at an average rate of 2.4 percent a year after 1996--the rate at which CBO estimates gross domestic product (GDP) can rise without triggering higher inflation.

CBO's economic and budget projections assume that current laws and policies governing federal spending and revenues will continue unchanged. The Congress and the President have separately advanced blueprints of major changes in those policies, but laws have not yet been enacted to carry out their proposals. The Congress has adopted a plan--a budget resolution--to reach a balanced budget in 2002. The plan assumes that discretionary spending in 2002 will be below the nominal level of appropriations provided for 1995 and that mandatory spending (excluding interest payments) will be $161 billion lower in 2002 than is projected under current law. The resolution also allows a tax cut of $245 billion over seven years if CBO certifies that the rest of the budget plan is being carried out as planned. In addition, the President has proposed a plan that the Administration estimates would produce a budget surplus in 2004 and 2005. According to CBO's estimates, however, achieving the savings proposed by the President--which are much smaller than those assumed by the budget resolution--would reduce the deficit to about $200 billion in those years.

Substantially slashing the deficit is likely to reduce interest rates and slightly increase economic growth compared with CBO's baseline economic projections. CBO has calculated that the economic improvements from balancing the budget by 2002 could cut interest costs and boost revenues for the federal government by $50 billion in 2002 and by a total of $170 billion in 1996 through 2002. The budget resolution takes this so-called fiscal dividend into account in calculating that the budget will be balanced even if the contingent tax cut is enacted.

The Economic Outlook

CBO forecasts that the economy will grow slowly this calendar year but will pick up next year. The forecast reflects both actual growth in the first half of 1995, which was slower than CBO expected in its winter forecast, and CBO's assessment that the economy is fundamentally sound. (CBO's winter forecast was published in January 1995 in *The Economic and Budget Outlook: Fiscal Years 1996-2000*.) CBO's longer-term economic projections are not substantially different than those it made in January. The economic forecast is based on current fiscal policy--it does not reflect potential changes that the Congress and the President have proposed.

The Forecast for 1995 and 1996

Sluggish demand in interest-sensitive areas such as residential construction and consumer durable goods (especially automobiles and furniture) held economic growth to an annual rate of 1.6 percent in the first six months of 1995. As a result, CBO forecasts that real GDP will increase by only 1.3 percent in 1995, on a fourth-quarter-to-fourth-quarter basis, which is significantly below the 2.5 percent envisioned for 1995 in the winter forecast (see Summary Table 1). As did most other forecasters, CBO considered whether the steep falloff from the rapid growth experienced in 1994 (4.1 percent) signaled a recession. CBO's forecast reflects the possibility that a recession could develop, but CBO has concluded that a higher probability exists that the economy will grow more rapidly in 1996. There is little evidence of the imbalances--rising inflation, swollen inventories, deteriorating balance sheets--that usually precede recessions.

CBO expects that the economy will grow by 2.3 percent in 1996. That rate is somewhat higher than the 1.9 percent it forecast last winter. CBO anticipated at that time that growth in 1995 would leave the economy a little above potential GDP (the level of real GDP that is consistent with a stable rate of inflation) and that a slight slowdown in 1996 brought on by restrictive monetary policy would bring it back in line with potential GDP. But slow growth in 1995 is likely to leave GDP near its potential level so that growth of 2.3 percent would not threaten an acceleration of inflation.

Interest rates on three-month Treasury bills have increased significantly from the unusually low 3.0 percent in 1993, but the 5.4 percent average rate forecast for 1995 is 0.8 percentage points (80 basis points) lower than CBO anticipated last winter. CBO expects that the rate will decline to 5.1 percent in 1996. The forecast for 10-year Treasury note rates--6.5 percent in 1995 and 6.4 percent in 1996--is also lower than was expected last winter. Moreover, weaker growth in 1995 is likely to push the expected unemployment rate somewhat higher than had been anticipated--to 5.7 percent in 1995 and 6.0 percent in

1996. The consumer price index for all urban consumers (CPI-U) is expected to increase at the moderate rate of 3.3 percent in 1995 and 3.4 percent in 1996, about the same as in the winter forecast.

Projections for the Years Beyond 1996

CBO projects that average annual real growth in GDP in 1997 through 2005 will be 2.4 percent--the rate at which CBO estimates potential real GDP will increase (see Summary Table 2). On average, the unemployment rate is expected to be about 6 percent during that period, a rate CBO estimates is consistent with steady inflation. Thus, CBO projects no additional inflationary pressures on average during the 1997-2005 period. The annual increase in the CPI-U is actually projected to fall from 3.4 percent in 1997 to 3.2 percent after 1998 because of a rebenchmarking of the index that the Bureau of Labor Statistics

Summary Table 1.
The CBO Forecast for 1995 and 1996

		Forecast	
	1994[a]	1995	1996
	Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP			
CBO summer	6.5	3.8	5.1
CBO winter	6.3	5.3	4.7
Real GDP[b]			
CBO summer	4.1	1.3	2.3
CBO winter	3.7	2.5	1.9
Consumer Price Index[c]			
CBO summer	2.6	3.3	3.4
CBO winter	2.8	3.2	3.4
	Calendar Year Average (Percent)		
Civilian Unemployment Rate			
CBO summer	6.1	5.7	6.0
CBO winter	6.1	5.5	5.7
Three-Month Treasury Bill Rate			
CBO summer	4.2	5.4	5.1
CBO winter	4.2	6.2	5.7
Ten-Year Treasury Note Rate			
CBO summer	7.1	6.5	6.4
CBO winter	7.1	7.7	7.0

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Boad.

a. The numbers for 1994 are actual values for CBO's summer forecast but are estimates for the winter forecast.

b. Based on constant 1987 dollars.

c. The consumer price index for all urban consumers (CPI-U).

has planned for that year. CBO projects that interest rates will hold steady throughout the 1997-2005 period at 5.1 percent for three-month Treasury bills and 6.7 percent for 10-year Treasury notes. None of these projections represent a significant change from CBO's winter assumptions. One indication of how little the projections have changed is that the current projection of real GDP in 2005 is $6,904 billion, only $7 billion higher than CBO projected last winter.

Those projections for 1997-2005 do not reflect any attempt to forecast cyclical fluctuations in the economy. Beyond the two-year forecast period (1995 and 1996), CBO projects a course for the economy that will bring GDP to a level slightly below estimated potential output, which is consistent with the average historical relationship between actual and potential GDP. CBO forecasts that actual real GDP will reach that point at the end of 1996. Thus, real GDP is projected to grow at the same rate as potential output during the 1997-2005 period. The projection for potential GDP is based on an analysis of fundamental factors such as growth in the labor force, productivity, and national saving.

The Budget Outlook

Although CBO projects that the deficit will be $13 billion less in fiscal year 1995 than it anticipated last April, the essential budget outlook under current law has not changed. (The April baseline was described in CBO's *An Analysis of the President's Budgetary*

Summary Table 2.
The Economic Forecast and Projections for Calendar Years 1995 Through 2005

	Actual	Forecast		Projected								
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Nominal GDP (Billions of dollars)	6,738	7,058	7,385	7,764	8,165	8,587	9,032	9,497	9,986	10,501	11,042	11,610
Real GDP (Billions of 1987 dollars)	5,344	5,481	5,584	5,715	5,851	5,992	6,135	6,282	6,432	6,586	6,743	6,904
Real GDP (Percentage change)	4.1	2.6	1.9	2.3	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Implicit GDP Deflator (Percentage change)	2.1	2.1	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
CPI-U (Percentage change)[a]	2.6	3.1	3.4	3.4	3.3	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Unemployment Rate (Percent)	6.1	5.7	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	5.4	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	6.5	6.4	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7

SOURCE: Congressional Budget Office.

a. CPI-U is the consumer price index for all urban consumers.

Proposals for Fiscal Year 1996.) The deficit of $161 billion that CBO projects for 1995 would be the smallest since 1989. Measured as a percentage of gross domestic product, the deficit, at 2.3 percent, would be the smallest since 1979. In addition, 1995 will mark the third consecutive year the deficit has declined since the record deficit of $290 billion was posted in 1992. Unfortunately, CBO expects that it will begin steadily rising again after 1995 if current budgetary policies are not changed, growing from $161 billion in 1995 to $189 billion in 1996 (see Summary Table 3). Assuming that discretionary spending increased at the rate of inflation after the caps on it expire in 1998, the deficit would reach $462 billion in 2005.

CBO's baseline economic and budgetary projections assume current policies will continue. In the case of revenues and mandatory spending, CBO estimates the receipts and outlays that will occur if no changes are made in existing laws governing taxes and mandatory programs. In the case of discretionary spending, which is controlled by annual appropriation legislation, CBO assumes compliance with the statutory limits that cap appropriations through 1998. For the years after 1998, CBO produces two projections of discretionary spending. One projection assumes that total discretionary spending after 1998 will equal the level of the 1998 limit adjusted for inflation. The other projection assumes that discretionary spending will be frozen at the dollar level of the 1998 limit.

In CBO's projections with discretionary inflation after 1998, the deficit will reach $288 billion (3.2 percent of GDP) by 2000. CBO's extended projections of spending and revenues for the 2001-2005 period show a deficit of $462 billion (4 percent of GDP) in 2005. The projected deficit in CBO's base-

Summary Table 3.
CBO Deficit Projections (By fiscal year)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
						In Billions of Dollars					
Baseline Total Deficit											
With discretionary inflation after 1998	161	189	218	229	261	288	308	340	375	414	462
Without discretionary inflation after 1998	161	189	218	229	243	250	247	256	264	275	292
						As a Percentage of GDP					
Baseline Total Deficit											
With discretionary inflation after 1998	2.3	2.6	2.8	2.8	3.1	3.2	3.3	3.5	3.6	3.8	4.0
Without discretionary inflation after 1998	2.3	2.6	2.8	2.8	2.9	2.8	2.6	2.6	2.5	2.5	2.5

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

line without discretionary inflation after 1998 also generally continues to grow, although at a slower rate. CBO projects that freezing discretionary spending at the 1998 level would hold the deficit to $250 billion in 2000 and $292 billion in 2005. As a percentage of GDP, the deficit would grow to 2.8 percent in 2000 but then would decline to 2.5 percent in 2005.

The rapid growth in spending for the two big mandatory federal health programs (Medicare and Medicaid) continues to be the primary force driving up the deficit in CBO's projections. CBO projects that spending for the two programs under current laws will increase at an average annual rate of about 10 percent a year. By 2005, the combined spending for Medicare and Medicaid ($690 billion) will represent more than one-quarter of total federal outlays, up from 18 percent in 1995. Projected spending for interest on the federal debt will grow at a significantly slower rate (6 percent a year on average) but will still increase substantially (from $233 billion in 1995 to $415 billion in 2005). Other nondiscretionary spending in total will also grow at approximately 6 percent a year, only about 1 percentage point faster than the nominal rate of growth of the economy.

Revenues are expected to total $1,357 billion in 1995, equal to 19.4 percent of GDP. CBO projects that revenues under current laws will grow at slightly less than a 5 percent average annual rate over the 1995-2005 period, declining a little relative to the size of the economy. By 2005, revenues will total $2,175 billion, or 19 percent of GDP.

The Budget Resolution and the Economic Implications of Balancing the Budget

The budget resolution adopted by the Congress in June proposes dramatic changes in fiscal policy. Because the laws needed to implement the Congressional plan have not yet been enacted, the proposed changes are not reflected in CBO's baseline economic and budgetary projections.

The budget resolution assumes a balanced budget in 2002. The President has also called for a balanced budget in the July *Mid-Session Review of the 1996 Budget*, although his target date is 2004. CBO projects that the deficit will be close to $350 billion in 2002 and more than $400 billion in 2004 if no changes are made in current policy and if discretionary spending grows at the rate of inflation after the caps expire in 1998. The budget resolution is essentially based on CBO's April 1995 baseline economic and budgetary projections (which, as explained above, differ little from CBO's revised baseline projections that are detailed in Chapters 1 and 2). It accepts, therefore, that substantial changes in current policies are required to achieve budgetary balance in 2002. By contrast, because the Administration believes that deficits under current policies will be substantially lower than CBO projects, the President has proposed smaller savings. CBO estimates that, if the savings proposed by the President are achieved, the deficit would be reduced to about $200 billion in 2004 instead of being eliminated.

The budget resolution proposes tight constraints on total discretionary spending. The outlays of $515 billion that it proposes for 2002 would be $30 billion less than CBO estimates for 1995. Under the resolution's plan, all of this cut would come in nondefense programs; defense spending in 2002 would be approximately the same in nominal terms as in 1995. However, funds available for defense would be about 17 percent below the amount needed to keep pace with inflation. In inflation-adjusted terms, spending proposed by the resolution for nondefense programs in 2002 would be more than 30 percent below current spending for those activities.

Holding total discretionary spending to the $515 billion proposed by the budget resolution for 2002 would save $121 billion in that year compared with CBO's baseline with discretionary inflation. That represents a little less than one-third of the savings needed to balance the budget in that year. Under the budget resolution, an additional $161 billion in savings would come from changes in mandatory spending programs. The resolution assumes that a total of $125 billion of those mandatory savings in 2002 will come from Medicare ($71 billion) and Medicaid ($54 billion), with additional savings in a number of other programs. The remaining $66 billion in deficit reduction needed to reach a balanced budget in 2002 will come from diminished interest payments if policy changes reduce the deficit (and federal debt) by the assumed amounts in 1996 through 2002. That reduction in debt-service costs does not include any savings from lower interest rates that could result from eliminating the deficit.

The revenue levels stated in the budget resolution differ from current-law projections by about $1 billion in total over the 1996-2002 period. The resolution does, however, anticipate a tax cut that would reduce revenues by $50 billion in 2002 and $245 billion in 1996 through 2002. But the budget resolution provides that the Congress may not consider the tax cut unless the other legislative proposals being considered as part of the deficit reduction process would produce a balanced budget in 2002.

Enacting the tax cut envisioned by the resolution would, of course, reduce revenues below the levels stated in the budget resolution. The resolution assumes that the revenue loss will be offset by savings resulting from the economic effects of balancing the budget, which also were not included in the stated budget resolution numbers. In its April 1995 report, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, CBO estimated that balancing the budget by 2002 would over time lower interest rates by 100 to 200 basis points (1 to 2 percentage points) and increase the annual rate of real growth by about 0.1 percentage point. The extent of those effects is uncertain. However, CBO's estimates represent the middle ground of economic analysis on the subject. CBO calculates that such economic improvements would produce a fiscal dividend--lower federal interest payments and higher revenues--that would reduce the deficit by $50 billion in 2002 and $170 billion over the 1996-2002 period. The budget resolution assumes that this fiscal dividend would offset the anticipated tax cut in 2002 and would partially offset it in earlier years.

The Debt Limit

Since the Second Liberty Bond Act was passed in 1917, the Congress has enacted a series of statutory limits on federal borrowing. The current debt limit is $4.9 trillion. The limit applies to virtually all debt issued by the Treasury, including debt held by trust funds and other government accounts. CBO estimates that at the end of the current fiscal year debt subject to the limit will total slightly less than $4.9 trillion. Of that amount, $3.6 trillion is debt held by the public. An additional $1.3 trillion will be held by trust funds (the Social Security trust funds account for $0.5 trillion and the Civil Service Retirement trust fund for $0.4 trillion), with the remaining debt held in other government accounts. The debt limit may have served a useful purpose in controlling deficits when most federal spending was subject to annual appropriations. But now that about two-thirds of spending is mandatory, the debt limit is an ineffective budgetary tool. In recent years, the need to increase the debt has primarily served to provide a must-pass vehicle to which other legislation can be attached.

Federal borrowing will push debt to the limit sometime early in fiscal year 1996. That borrowing is driven both by spending that exceeds revenues (even under the budget resolution, deficit spending will continue until 2002) and by trust fund surpluses (those will require increases in the debt limit even after the budget has been balanced). Under normal operations, debt is likely to hit the ceiling sometime in October, though the Treasury may be able to delay any serious difficulties until November. At that point, however, if the debt limit has not been increased, the government will have to choose between defaulting on its obligations (such as paying Social Security benefits and interest on government securities) or taking steps (such as disinvesting trust funds) to free up room under the limit to allow additional borrowing from the public.

Debt has run up against the limit on a number of previous occasions. Those debt crises have been short-lived, however, and the Treasury has always managed to deal with them without taking any extreme actions. The United States government has never been forced to default on any obligations. A default could have grave consequences, prompting a loss of confidence in the government and a permanent increase in federal borrowing costs as investors decide that government debt is no longer free of risk of default.